

03,034 259 2011

Appearances

Michael J. Newman, Senior Regional Counsel, and Jonathan Prytherch, Senior Regional Counsel, Woodbridge, NJ, for the Department of Enforcement.

Martin H. Kaplan, Esq., and Martin P. Russo, Esq., for Respondents David L. Smith and Timothy M. McGinn.¹

DECISION

I. Introduction

The Department of Enforcement filed the Complaint in this matter on April 6, 2010. The Complaint arises from four allegedly fraudulent unregistered securities offerings made by McGinn, Smith & Co., Inc. (the "Firm"), between September 2003 and November 2006 involving the sale of approximately \$89 million in income notes to a total of approximately 515 investors. Smith is charged in the first five causes of action; both Smith and McGinn are charged in the sixth.² The Complaint alleges that:

- Smith violated NASD Rules 2110 and 2330 by misusing approximately \$51 million of investor funds, and lending approximately \$590,000 of investor funds to himself;
- Smith violated Section 10(b) of the Exchange Act and Rule 10b-5, and NASD Rules 2110, 2120, and IM-2310-2 by making material misrepresentations and failing to disclose numerous material facts in connection with the four offerings;
- Smith violated NASD Rule 2110 by selling unregistered securities;
- Smith further violated NASD Rule 2110 by making material misrepresentations and omissions to investors in letters he sent to them about their investments;

¹ Counsel filed a Notice of Withdrawal of their representation of Respondents Smith and McGinn on January 12, 2011. From that time, Smith and McGinn represented themselves.

² Five of the six causes of action also named the Firm as Respondent. However, on April 20, 2010, the United States District Court for the Northern District of New York issued an Order to Show Cause, Temporary Restraining Order and Order Freezing Assets and Granting Other Relief ("TRO"), in *SEC v. McGinn, Smith & Co., Inc., et al.*, No. 10-CV-457 (N.D. N.Y.). See CX-15. The order directed, in relevant part, that "[N]o person or entity, shall take any action without further order of this Court to interfere with the taking control, possession, or management of the assets, including but not limited to the filing of any lawsuits ... to impact the property and assets subject to this order." Citing the TRO, on July 8, 2010, the Hearing Officer issued an order that stayed the Department of Enforcement's proceeding against the Firm.

- Smith violated NASD Rules 2110 and 3010 by failing to establish and maintain a supervisory system and enforce procedures reasonably designed to achieve compliance with FINRA rules and securities laws applicable to private securities offerings; and
- Smith and McGinn both violated FINRA Rules 2010 and 8210 by submitting falsified documents to FINRA in response to requests for documents made pursuant to Rule 8210.

Respondents David L. Smith and Timothy M. McGinn (collectively referred to as "Respondents") filed their Answer on June 10, 2010. The hearing was scheduled for May 16-26, 2011, in Albany, New York.

Respondents failed to appear when the Extended Hearing Panel convened the hearing on May 16, 2011. The Extended Hearing Panel admitted exhibits offered by Enforcement and heard testimony from several of Respondents' former customers who had traveled to Albany to testify at the hearing.

On June 23, 2011, Enforcement filed a Motion for Entry of Default Decision and Request for Sanctions ("Default Motion"), supported by the Declaration of Michael J. Newman, as well as the testimony and exhibits received into evidence at the hearing.³

II. Findings of Fact and Conclusions of Law

A. Respondents Are Subject to FINRA Jurisdiction

McGinn, Smith & Co., Inc. was a FINRA member firm from January 9, 1981, to August 13, 2010.⁴ During the period relevant to the charges in the Complaint, Smith was President, Chief Compliance Officer, and majority owner of the Firm. McGinn was Chairman of the Board

³ The exhibits will be referred to as "CX-_" with the appropriate exhibit number. References in this Default Decision to the Declaration will be referred to as "Decl." or "Newman Decl." References to the transcript of proceedings at the hearing will be referred to as "Hrg. Tr. _" with the appropriate page reference. References to transcripts of pre-hearing conferences will be referred to as "PHC Tr." with the date and citation to the appropriate page.

⁴ Decl. ¶ 5, n. 1.

and an owner of the Firm. Smith and McGinn were registered with FINRA as General Securities Principals as of November 25, 1980, and their registrations were terminated on August 13, 2010.⁵

Neither Smith nor McGinn is currently registered with a FINRA member firm. Both remain subject to FINRA's jurisdiction, however, pursuant to Article V, Section 4, of FINRA's By-Laws because (i) the Complaint was filed within two years following the termination of their registrations with a FINRA member firm, and (ii) the Complaint charges Respondents with misconduct that occurred while they were registered with a FINRA member firm.⁶

B. Respondents Defaulted

Respondents defaulted when they failed to appear at the hearing.

The initial scheduling order was issued on July 28, 2010, and set the hearing in this case for May 2-20 and June 6-10, 2011.⁷ On February 11, 2011, a revised scheduling order changed the hearing dates to May 16-26 and June 7-10, 2011.⁸

Respondents participated in a pre-hearing conference on March 21, 2011. During the conference, Respondents pointed out that the Securities and Exchange Commission had filed a case against them. They made an oral request that this proceeding be stayed pending the outcome of the SEC case. They represented that the hearing date for the SEC case would be in March 2012. Their oral request for a stay was denied.

Pursuant to FINRA Procedural Rule 8210, Enforcement issued a notice to Respondents on March 31, 2011, requiring them to appear to testify at the hearing.⁹ On April 26, 2011, the

⁵ Decl. ¶¶ 5, 7.

⁶ Decl. ¶¶ 6, 8.

⁷ Decl. ¶ 13.

⁸ Decl. ¶ 14.

⁹ Enforcement sent the notices to Respondents at their residential addresses as reflected in the Central Registration Depository ("CRD addresses") and to their e-mail addresses, which they had provided to Enforcement through counsel early in the case. Decl. ¶¶ 15-16.

Notice of Hearing was issued to all parties confirming the hearing dates, directing that the hearing would begin on May 16, 2011, at a specified address in Albany, New York.¹⁰

Finally, on May 11, 2011, both Respondents participated in the Final Pre-Hearing Conference. At the conference, Smith explained that the Respondents had filed a motion in the United States District Court for the District of Columbia requesting the issuance of a temporary restraining order to stay this proceeding until the completion of the SEC case. Smith represented that he would attend the hearing in this case unless the United States District Court issued the temporary restraining order.¹¹ During the conference, McGinn stated that he was en route to Albany to attend the hearing.¹²

On Saturday, May 14, 2011, at approximately 5:00 p.m., Smith sent an e-mail to the Office of Hearing Officers, with a copy to Enforcement, stating that upon counsel's advice, Respondents would not attend the hearing.¹³

On Sunday, May 15, 2011, the day prior to the start of the hearing, the District Court denied Respondents' motion for a stay.¹⁴

When the hearing convened on May 16, 2011, and Respondents failed to appear,¹⁵ a telephone call was placed to each. Neither answered the call placed to him.¹⁶

¹⁰ Decl. ¶ 17.

¹¹ Smith also said that he would rely on the advice of the attorney representing Respondents in the SEC case as to whether they should appear at the hearing, but noted that the attorney had previously declined to advise them on anything related to this proceeding. Decl. ¶ 18; PHC Tr. May 11, 2011, at 4-6.

¹² Decl. ¶ 18; PHC Tr. May 11, 2011, at 6.

¹³ Hrg. Tr. at 4. The e-mail was admitted into evidence at the hearing as CX-136. In the e-mail, Smith stated that counsel had advised them not to appear and testify so long as the motion for a temporary restraining order that Respondents had filed was pending in the U.S. District Court for the District of Columbia.

¹⁴ Hrg. Tr. at 6; CX-137.

¹⁵ Hrg. Tr. at 2-4.

¹⁶ Hrg. Tr. at 10-13.

By failing to appear at the hearing as directed by orders issued by the Hearing Officer, and the notices issued by Enforcement pursuant to Rule 8210, Respondents defaulted. Accordingly, pursuant to Rules 9215(f) and 9269(a)(2), and for the reasons given below, the Default Motion is granted.¹⁷

C. Smith Misused Investor Funds

From September 2003 to November 2006, in four offerings to investors, Smith sold approximately \$89 million in income notes issued by four limited liability companies ("Income Note LLCs") that he controlled.¹⁸ Smith told the investors that the Income Note LLCs would place their funds in a broad array of public and private investments. Contrary to Smith's representations, however, he diverted most of the invested funds for the benefit of a number of business entities that he and McGinn owned or in which they had a financial interest.¹⁹ Smith also loaned approximately \$590,000 of the funds directly to himself.²⁰

These facts, as alleged in the Complaint's First Cause of Action and supported by the Newman Declaration, sufficiently establish, for the purposes of this Default Decision, that Smith misused investor funds, in violation of NASD Conduct Rules 2110 and 2330.²¹

¹⁷ The factual determinations in this Default Decision are based on the allegations of the attached Complaint, which are deemed admitted, as well as the Newman Declaration, the transcripts of the pre-hearing conferences and the hearing, and the testimony and exhibits filed by Enforcement and received into evidence at the hearing.

¹⁸ Decl. ¶ 9.

¹⁹ Decl. ¶ 21.

²⁰ Complaint ¶ 32.

²¹ As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this Decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA Consolidated Rulebook. The first phase of the new consolidated rules became effective on December 15, 2008, including certain conduct rules and procedural rules. *See* Regulatory Notice 08-57 (Oct. 2008). With the exception of the Sixth Cause of Action, Smith's misconduct alleged in the first five causes of action of the Complaint occurred prior to the effective date of the new consolidated rules. For those charges, this Decision refers to and relies on the NASD Conduct Rules that were in effect at the time the misconduct occurred. The applicable rules are available at www.finra.org/rules.

D. Smith Made Misrepresentations and Omissions of Material Facts in Connection with the Sales of Securities

Intentional misrepresentations as to how offering proceeds will be used, and use of proceeds from investors contrary to representations made to investors, constitute fraudulent conduct.²²

When Smith recommended to investors that they participate in the private offerings and purchase the income notes, he made misrepresentations and omissions of material facts relating to the Income Note LLCs. In addition to falsely representing that the Income Note LLCs would place their funds in private and public investments, Smith stated that the Firm would charge an annual commission or fee of only two percent. In actuality, the proceeds of the investments were diverted to entities owned by Smith and McGinn, which were illiquid and in poor financial condition with little or no revenues, and the Firm charged recurring annual commissions or fees amounting to approximately eight percent of the investors' purchases. Smith failed to inform investors that the Income Note LLCs would invest in, and make loans to, entities in which he and McGinn maintained a financial interest, and that the majority of the funds would be invested in illiquid, non-public companies.²³

These facts, as alleged in the Complaint's Second Cause of Action and supported by the Newman Declaration, provide a sufficient basis, for the purposes of this Default Decision, to establish that Smith made material misrepresentations and omissions in connection with the sales of income notes, in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and NASD Conduct Rules 2110, 2120, and IM-2310-2.

²² *Brian Prendergast*, Exch. Act Rel. No. 44632, 2001 SEC LEXIS 1533, at *23 (Aug. 1, 2001) (description of disposition of proceeds in an offering document is material information; issuers must apply proceeds as promised).

²³ Complaint ¶¶ 3-5, 37, 39.

E. Smith Sold Unregistered Securities

Section 5 of the Securities Act of 1933 prohibits anyone from offering or selling a security by use of the mails or interstate commerce unless it is registered with the SEC or there is an exemption to the registration requirement available.²⁴ Scienter is not an element of a Section 5 violation.²⁵ A violation of the requirements of Section 5 is a violation of NASD Conduct Rule 2110.²⁶

Smith directed the sales efforts by which customers purchased income notes issued by the four LLCs.²⁷ The notes were not registered with the SEC and were not eligible for exemption from registration.²⁸ The offerings claimed to be exempt from the registration requirement pursuant to Rule 506 of the Securities Act of 1933, Regulation D, but were ineligible for exemption because there were more than 35 non-accredited investors in each offering, and a total of approximately 250 non-accredited investors in the four offerings.²⁹

These facts, as alleged in the Complaint's Third Cause of Action and supported by the Newman Declaration, provide a sufficient basis, for the purposes of this Default Decision, to establish that Smith sold unregistered securities, in contravention of Section 5 of the Securities Act of 1933, and thereby in violation of NASD Conduct Rule 2110.

²⁴ *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 859-60 (S.D.N.Y. 1997), 1997 U.S. Dist. LEXIS 3139, *aff'd*, 159 F.3d 1348 (2d Cir. 1998).

²⁵ *Aaron v. SEC*, 446 U.S. 680, at *714 n.5, 1980 U.S. LEXIS 107 (1980), citing *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 541-42, 1973 U.S. App. LEXIS 6683 (1973).

²⁶ *Alvin W. Gebhart*, Exch. Act Rel. No. 53136, 2006 SEC LEXIS 93, at *53-54, n.75 (Jan. 18, 2006).

²⁷ Complaint ¶ 45.

²⁸ Complaint ¶ 46.

²⁹ Complaint ¶¶ 46-47, 49.

F. Smith Made Misrepresentations and Omissions of Material Facts in Communications with Investors

Smith sent two letters, one in January 2008 and the other in October 2008, to income note investors containing material misrepresentations and omissions concerning their investments.³⁰

In the January 2008 letter, Smith informed certain note holders of all four Income Note LLCs that their annual interest rates of return would be reduced from 10.25% to 5% because of market conditions. In the letter, Smith falsely represented that the Firm, which had been charging fees or commissions from the Income Note LLCs, would suspend collection of further fees. To the contrary, the Firm continued to charge fees and commissions, totaling approximately \$6.7 million from 2008 to 2010.³¹

In the October letter, sent to all holders of the Income Note LLCs, Smith informed them that they would be unable to redeem notes on November 15, 2008, because of conditions in financial credit markets and the resultant "liquidity crises." Smith also falsely represented that the Firm would "forfeit" all annual fees and commissions in order to improve the liquidity of the Income Note LLCs. As noted above, this was untrue; the Firm continued to charge fees and commissions.³²

In both letters, Smith failed to disclose to the note holders that the poor financial condition of the Income Note LLCs was caused in part by his decision to lend or invest most of the investors' funds in illiquid entities that he and McGinn owned and controlled, had few or no revenues, and were in financial distress.³³

³⁰ Decl. ¶ 27.

³¹ Complaint ¶¶ 52-54.

³² Complaint ¶¶ 55-57, 59.

³³ Complaint ¶ 58.

These facts, as alleged in the Complaint's Fourth Cause of Action and supported by the Newman Declaration, provide a sufficient basis, for the purposes of this Default Decision, to establish that Smith made material misrepresentations and omissions of material fact, in violation of NASD Conduct Rule 2110.

G. Smith Failed to Establish and Maintain a Supervisory System and Enforce Procedures Reasonably Designed to Achieve Compliance with Applicable FINRA Rules and Securities Laws

From approximately 2003 through 2008, the Firm's principal source of revenues was from private placements, including the four income note offerings.³⁴ The Firm, through Smith, failed to establish and maintain a supervisory system, and failed to establish, maintain, and enforce written supervisory procedures, that were reasonably designed to achieve compliance with the applicable FINRA rules and securities laws related to suitability, disclosure, and verification of investor accreditation status.³⁵

For example, subscription contracts submitted by potential investors in income note offerings were inadequate because they did not contain information about the investors' liquid net worth. Nonetheless, the Firm relied on them to review and approve individual investments. Furthermore, many investor documents were incomplete. Many were altered after they were submitted by the investors to make it appear that the investors had a higher net worth, and qualified as accredited investors.³⁶ The Firm did not have, and Smith did not implement, procedures for reviewing customer documents reasonably designed to allow the Firm to identify any potential alterations and to take appropriate action, and did not have a procedure for spot-checking customer documents and contacting customers directly to ascertain if the documents

³⁴ Complaint ¶ 62.

³⁵ Complaint ¶ 63.

³⁶ Complaint ¶¶ 64-65; CX-110, at 4; CX-111, at 4; CX-112, at 9.

were accurate.³⁷ Despite the fact that the Private Placement Memoranda for the income notes and subscription agreements provided that only accredited investors would be eligible to invest, Smith approved and accepted investments from approximately 250 non-accredited investors.³⁸

These facts, as alleged in the Complaint's Fifth Cause of Action and supported by the Newman Declaration and exhibits filed by Enforcement, provide a sufficient basis, for the purposes of this Default Decision, to establish that Smith violated NASD Conduct Rules 2110 and 3010.

H. Smith and McGinn Provided False Documents to FINRA

On September 30, 2009, pursuant to FINRA Procedural Rule 8210, FINRA Staff sent a letter to the Firm requesting all documentation relating to loans received by Smith, McGinn, and other Firm employees from certain business entities controlled by Smith and McGinn.³⁹ On November 16, 2009, Smith and McGinn submitted copies of 23 promissory notes relating to the loans; six were signed by Smith as borrower, 14 were signed by McGinn as borrower, and the remaining notes were signed by a registered representative of the Firm.⁴⁰ The notes were dated to appear that they had been signed between October 2006 and October 2009.⁴¹ Each note contained a certification attesting that it had been executed and delivered on the date specified.⁴² The certifications were false; the notes had actually been prepared, dated, and signed by Smith, McGinn, and the registered representative between November 2 and November 15, 2009.⁴³

³⁷ CX-21, at 59-60.

³⁸ Complaint ¶ 68.

³⁹ Complaint ¶ 71.

⁴⁰ Complaint ¶¶ 72-74.

⁴¹ Complaint ¶ 75; CX-48.

⁴² Complaint ¶ 76.

⁴³ Complaint ¶¶ 75-78; Decl. ¶ 31-32; CX-26, at 215-224.

These facts, as alleged in the Complaint's Sixth Cause of Action, supported by the Newman Declaration and exhibits filed by Enforcement, are sufficient to establish, for the purposes of this Default Decision, that Respondents provided false documents to FINRA, in violation of FINRA Conduct Rule 2010 and Procedural Rule 8210.

III. Sanctions

Enforcement recommends that both Respondents be barred, consistent with the FINRA Sanction Guidelines and the aggravating circumstances surrounding Respondents' misconduct.⁴⁴

A. Smith

1. Misuse of Funds

The Sanction Guidelines for misuse of funds, or conversion, state that a bar is the standard sanction without regard to the amount of money misused, unless a mitigating circumstance exists.⁴⁵ Here, there is no evidence of mitigating circumstances. There are, however, aggravating circumstances. Smith misused investor funds over a period spanning almost four years, in a pattern of misconduct consisting of numerous acts.⁴⁶ Furthermore, Smith profited substantially from the misuse, since he diverted millions of dollars as loans to business entities of which he was an owner, and approximately \$590,000 to himself in the form of personal loans.⁴⁷ For these reasons, a bar is the appropriate sanction.

⁴⁴ Enforcement does not seek restitution to customers for losses suffered as a result of Smith's misuse of investor funds, fraudulent misrepresentations and omissions in connection with sales of the note offerings, and other misconduct. Because of the pendency of the Memorandum Decision and Order continuing the TRO and the freeze of Respondents' assets, *SEC v. McGinn, Smith & Co., Inc., et al.*, 10-CV-457, 752 F. Supp. 2d 194, 2010 U.S. Dist. LEXIS 125862, at *9-10 (July 7, 2010), an order for restitution is inappropriate.

⁴⁵ *FINRA Sanction Guidelines*, at 36 (2011).

⁴⁶ *Sanction Guidelines*, Principal Consideration Nos. 8, 9, at 6.

⁴⁷ *Sanction Guidelines*, Principal Consideration No. 17, at 7.

2. False Representations and Omissions of Material Facts

For intentionally making false representations or omissions of material fact in connection with the sale of securities, the Sanction Guidelines recommend a fine of \$10,000 to \$100,000, and a suspension in any and all capacities for a period of 10 business days to two years, or, in egregious cases, a bar.⁴⁸ Smith's failure to disclose how the investors' funds would be used and misrepresentations as to the fees that the Firm would charge were material and intentional. As such, Smith's misconduct was egregious, and a bar is the appropriate sanction.⁴⁹

3. Sales of Unregistered Securities

For sales of unregistered securities, the Sanction Guidelines recommend a fine of \$2,500 to \$50,000, and, in egregious cases, a higher fine, and a suspension in any or all capacities for up to two years or a bar.⁵⁰ As noted above, no registration statement was in effect for the four income notes sold at Smith's direction over a period of three years. The egregiousness of this misconduct makes a bar the appropriate sanction.

4. Misrepresentations and Omissions in Communications with Investors

For intentional misrepresentations or omissions of fact to customers, the Sanction Guidelines recommend a fine of \$10,000 to \$100,000 and a suspension in any or all capacities for 10 business days to two years, or, in egregious cases, a bar.⁵¹

In this case, Smith's misleading letters went to all of the note holders and were designed to mislead them about the reasons for delays in the redemption of their notes, and to give false assurances that the Firm was ceasing to charge fees in response to the financial problems

⁴⁸ *Sanction Guidelines*, at 90.

⁴⁹ *Prendergast*, at *40-41.

⁵⁰ *Sanction Guidelines*, at 24.

⁵¹ *Sanction Guidelines*, at 90.

attributable to conditions in financial credit markets. In this regard, the letters were intended to prevent the investors from learning that Smith and McGinn had used their funds for their own purposes. Smith's letters thus were similar in nature to false account statements because they misrepresented the state of the customers' investments, and Smith's conduct in sending them was "the antithesis of a registered representative's {duty to uphold} high standards of commercial honor."⁵² For these reasons, a bar is the appropriate sanction.

5. Supervisory Violations

Smith was the Firm's chief compliance officer and a supervisory principal. His failures to establish and maintain a supervisory system, and to maintain and enforce written supervisory procedures reasonably designed to achieve compliance with the applicable securities laws and regulations pertaining to private securities offerings and suitability, disclosure, and verification of investor accreditation, were serious. This is underscored by the fact that during the relevant period, the Firm's principal business was derived from private offerings, including the four income notes that are the focus of this case.

The Sanction Guidelines recommend consideration of a suspension of up to two years or a bar for the responsible individual in egregious cases of failures of supervision. The Principal Considerations include the nature, extent, size, and character of the underlying misconduct.⁵³ In light of the extensive and egregious failures here, a bar is the appropriate sanction for Smith.

⁵² *Dep't of Enforcement v. Dunbar*, 2008 FINRA Discip. LEXIS 18, at *16 (N.A.C. May 20, 2008), quoting *Dep't of Enforcement v. Abbondante*, No. C10020090, 2005 NASD Discip. LEXIS 43, at *31-32 (N.A.C. Apr. 5, 2005), *aff'd*, Exch. Act Rel. No. 53066, 2006 SEC LEXIS 23 (2006), *petition denied*, 209 Fed. App. 6 (2d Cir. 2006) (unpublished) (citing *Dist. Bus. Conduct Comm. v. Mangan*, No. C10960162, 1998 NASD Discip. LEXIS 33, at *16 (N.A.C. July 29, 1998)).

⁵³ *Sanction Guidelines*, at 105.

6. Smith and McGinn: Providing False Documents to FINRA

The SEC has held that supplying false information to FINRA in response to requests for information made in the course of an investigation is comparable to refusing to respond at all, as the result is to mislead and possibly to conceal wrongdoing. Consequently, such misconduct has been deemed to render someone who supplies false information "presumptively unfit for employment in the securities industry."⁵⁴ The Sanction Guidelines state that a bar should be the standard sanction for failing to respond at all to requests for information made pursuant to FINRA Rule 8210, or for providing a partial or incomplete response.⁵⁵ In this case, the record establishes that the false responses were willfully and intentionally created, clearly intended to mislead FINRA staff by concealing facts, and that they were numerous. There is no mitigating evidence in the record.

Thus, a bar is the appropriate sanction for Smith and McGinn for falsifying documents in response to a FINRA request for information issued to them pursuant to Rule 8210.

IV. Order

Respondent David L. Smith is barred from associating with any FINRA member firm in any capacity for (i) misusing investor funds, in violation of NASD Rules 2110 and 2330; (ii) making misrepresentations and omissions of material facts in connection with the sales of securities, in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and NASD Rules 2110, 2120, and IM-2310-2; (iii) selling unregistered securities, in violation of NASD Rule 2110; (iv) making misrepresentations and omissions of material fact in communications with investors, in violation of NASD Rule 2110; and (v) failing to establish and maintain a supervisory system and to establish, maintain, and enforce written supervisory

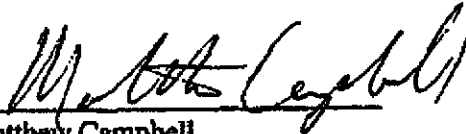
⁵⁴ *Geoffrey Ortiz*, Exch. Act Rel. No. 58416, 2008 SEC LEXIS 2401, *32-33 (Aug. 22, 2008).

⁵⁵ *Sanction Guidelines*, at 33.

procedures reasonably designed to achieve compliance with the applicable securities laws and FINRA rules related to private securities offerings, suitability, disclosure, and verification of investor accreditation status, in violation of NASD Rules 2110 and 3110.

Respondents David L. Smith and Timothy M. McGinn are barred for providing false documents to FINRA in response to requests for information issued pursuant to FINRA Rule 8210, in violation of FINRA Rules 2010 and 8210.

If this Default Decision becomes FINRA's final disciplinary action in this proceeding, the bars will become effective immediately.


Matthew Campbell
Hearing Officer

Copies to:

David L. Smith (*via e-mail, overnight courier, and first-class mail*)
Timothy M. McGinn (*via e-mail, overnight courier, and first-class mail*)
Jonathan M. Prytherch, Esq. (*via e-mail and first-class mail*)
Michael J. Newman, Esq. (*via e-mail and first-class mail*)
Mark P. Dauer, Esq. (*via e-mail*)
David R. Sonnenberg, Esq. (*via e-mail*)

FINANCIAL INDUSTRY REGULATORY AUTHORITY

OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

COMPLAINANT.

v.

**McGINN, SMITH & CO., INC.
(BD No. 8453),**

**DAVID L. SMITH
(CRD No. 427284),**

AND

**TIMOTHY M. MCGINN
(CRD No. 813935),**

RESPONDENTS.

**DISCIPLINARY PROCEEDING
No. 2009017984501**

COMPLAINT

The Department of Enforcement alleges:

SUMMARY

1. From in or about September 2003 through in or about November 2006 (the Offering Period), McGinn, Smith & Co., Inc. (the Firm), acting through David L. Smith (Smith), the President and an owner of the Firm, conducted four fraudulent unregistered securities offerings involving the sale of approximately \$89 million in income notes. The notes were issued by four limited liability companies (hereafter Income Note LLCs) managed and controlled by Smith.

2. The income notes, which are securities, were not registered or eligible for an exemption from registration. In offering the notes, the Firm and Smith ostensibly relied upon the exemption provided by Rule 506 of the Securities Act of 1933 (Regulation D). That exemption, however, was not available because, among other things, the four income note offerings had, individually and collectively, in excess of 35 non-accredited investors.
3. Note investors were promised that their funds would be earmarked for a broad array of public and private investments. Instead, Smith, acting on behalf of the investment advisor for the Income Note LLCs, misused the majority of offering proceeds for his own needs and to benefit entities that he, Timothy M. McGinn (McGinn) and/or TL owned, controlled, and/or in which they maintained a financial interest (the Related Entities). Moreover, most of the Related Entities were illiquid and had little or no revenues, or were in poor financial condition, at the time they received the offering proceeds from the Income Note LLCs.
4. Smith misused approximately \$51 million of investor funds, directing approximately \$17 million to the Related Entities and approximately \$34 million more to make loans to those companies. Smith and the Related Entities received a direct financial benefit from these transactions. For example, Smith received personal loans of approximately \$590,000 from the Related Entities that were funded by investments made in the Income Note LLCs. Smith controlled, and had an ownership interest in, the investment advisor for the Income Notes LLCs. The Firm, acting through Smith, failed to disclose the related party transactions and lending activity to the income note investors.

5. During the Offering Period, the Firm and Smith also misrepresented to investors that the Firm would only receive a two percent underwriting/commission fee from the income note offerings. In fact, the Firm received recurring annual commissions from the inception of the offerings, totaling approximately \$7.5 million (approximately eight percent of the offering proceeds).
6. The Income Note LLCs defaulted on the income notes. In 2008, Smith sent two letters to the income note holders misrepresenting that the Firm and two of the Related Entities, McGinn, Smith Advisors, LLC, and McGinn, Smith Capital Holdings Corp. (the McGinn Smith Affiliates), would waive or forgo further fees and commissions due to the poor financial condition of the income note issuers. Contrary to those representations, however, the Firm and the McGinn Smith Affiliates subsequently took approximately \$6.7 million in fees and commissions.
7. Throughout the Offering Period, the Firm, acting through Smith, also failed to establish and maintain a supervisory system, and failed to establish, maintain and enforce written supervisory procedures that were reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules applicable to private securities offerings and related suitability, disclosure, verification of investor accreditation status and other sales practice-related issues.
8. Finally, in response to a FINRA request for information in September 2009, the Firm, acting through Smith and fellow owner McGinn, provided the staff with falsified documents, submitting copies of backdated promissory notes for personal loans they

(and others) received from two of the Related Entities from October 2006 through October 2009.

9. This conduct violated NASD Conduct Rules 2110, 2120, 2330 and 3010, IM-2310-2, and FINRA Rules 8210 and 2010, and willfully violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder.

RESPONDENTS AND JURISDICTION

10. The Firm has been a member of FINRA since January 9, 1981. It is based in Albany, New York and conducts a general securities business. The Firm derives most of its revenues from private offerings and investment advisory services. The Firm is owned by Smith (50%), McGinn (30%) and TL (20%).
11. Smith has been the President and part owner of the Firm since it became a FINRA member. On April 9, 1973, he first became registered with FINRA as a general securities representative. Smith was the Firm's President and Chief Compliance Officer during the time period of the violations alleged herein. On November 25, 1980, Smith also became registered with FINRA as a general securities principal. He holds several other securities licenses as well.
12. Smith is the President and 50% owner of McGinn Smith Holdings, LLC, the holding company that owns McGinn Smith Capital Holdings Corp. and McGinn Smith Advisors, LLC.
13. McGinn Smith Advisors, LLC was the sole owner and investment advisor for the Income Note LLCs. Those entities paid an annual advisory fee of 1% to McGinn Smith Advisors, LLC. McGinn Smith Capital Holdings Corp. received a 0.25% annual "servicing fee" from the Income Note LLCs.

14. McGinn has been the Chairman of the Board and part owner of the Firm since it became a FINRA member. On October 18, 1975, he first became registered with FINRA as a general securities representative. On November 25, 1980, he also became registered as a general securities principal. McGinn is a 30% owner of McGinn Smith Holdings, LLC.

OVERVIEW OF FRAUDULENT OFFERINGS

15. The Firm, acting through Smith, sold approximately \$89 million in income notes through four private offerings. In offering the notes, the Firm and Smith ostensibly relied upon the exemption provided by Regulation D. The issuers, First Independent Income Notes, LLC, First Excelsior Income Notes, LLC, Third Albany Income Notes, LLC and First Advisory Income Notes, LLC, were created and managed by Smith.

16. The four offerings occurred from on or about September 25, 2003 through on or about November 15, 2006 and raised the following amounts:

- *First Independent Income Notes, LLC (FINN)*
Offering Period: Sept 2003 – December 2004
Approximately \$20 million
- *First Excelsior Income Notes, LLC (FEIN)*
Offering Period: January 2004 - January 2005
Approximately \$21 million
- *Third Albany Income Notes, LLC (TAIN)*
Offering Period: November 2004 - December 2005
Approximately \$30 million
- *First Advisory Income Notes, LLC (FAIN)*
Offering Period: October 2005 – November 2006
Approximately \$18 million

17. Although the offerings commenced during different periods, they overlapped with each other insofar as, after the first of these offerings, there was always at least one or more of the other offerings ongoing at the time a new offering commenced.
18. All of the note offerings had the same structure and were sold pursuant to a "Confidential Private Placement Memorandum" (PPM) that contained virtually identical disclosures, terms and information. Each investor was also required to complete an Investor Questionnaire and Subscription Agreement.
19. A total of approximately 515 investors purchased notes in the four offerings.
20. The PPMs for all four offerings were prepared at Smith's direction and were reviewed by him for accuracy prior to commencement of each offering.
21. Each issuer offered the same security (and structure), providing for three classes or tranches of income notes with different maturity dates and interest payments. "Secured Senior Notes" typically were due within one year and offered interest payments of 5% to 6%, while "Secured Senior Subordinated Notes" and "Secured Junior Notes" matured within three to five years and paid the highest interest ranging from 7.5% to 10.25%. The Senior Subordinated Note holders' and Junior Note holders' rights to receive payments were subordinated in rights of payment to the Senior Note holders.
22. The PPMs promised investors that they would receive quarterly interest payments.
23. After raising approximately \$89 million, the Income Note LLCs have defaulted on the notes. The vast majority of the investments held by the Income Note LLCs are illiquid and non-performing. In 2008, Smith, acting on behalf of the Income Note

LLCs, stopped all redemptions and has only made reduced quarterly interest payments to one of the three classes of income note holders.

FIRST CAUSE OF ACTION

MISUSE OF PROCEEDS (NASD CONDUCT RULES 2330 AND 2110)

24. The Department realleges and incorporates by reference paragraphs 1-23 above.
25. The PPMs that the Firm distributed to purchasers of the Income Note LLCs' notes promised investors that their funds would be earmarked for a broad array of public and private investments. Instead, Smith, acting on behalf of the investment advisor for the Income Note LLCs, misused the majority of offering proceeds for his own needs and to benefit the Related Entities.
26. From in or about November 2003 through in or about October 2007, Smith, acting on behalf of the investment advisor for the Income Note LLCs, misused approximately \$51 million of investor funds, directing approximately \$17 million to 3 Related Entities and approximately \$34 million more to make loans to 23 other Related Entities.
27. Most of the Related Entities were illiquid and had little or no revenues, or were in poor financial condition, at the time they received offering proceeds from the Income Note LLCs. Some of the Related Entities used those funds to make required payments to investors in earlier offerings involving the Firm, Smith and McGinn. Most of the Income Note LLCs' investments and loans in the Related Entities have not been profitable and have yielded limited or no returns.

28. Approximately \$22 million of the loans to the Related Entities have still not been repaid.

29. The PPMs for the Income Note LLCs failed to disclose that the LLCs would be making investments in any of the Related Entities.

30. The PPMs for the Income Note LLCs failed to disclose that the LLCs would be making loans to any of the Related Entities.

31. Smith and the Firm received financial benefits from the transactions involving the Related Entities. For example, Smith caused the Income Note LLCs to use the income note offering proceeds for some the following loans and investments:

- approximately \$2 million in loans in October 2007 to 107A, an LLC solely owned by McGinn Smith Holdings, LLC. These funds were used to make an investment in another private offering involving one of the Related Entities. This investment allowed that entity to meet its minimum offering requirement and break escrow, thereby allowing the Firm to receive approximately \$635,000 in underwriting fees. This loan remains outstanding;
- approximately \$7 million in loans from in or about November 2004 through in or about January 2007 to CCL, an LLC in which Smith held an ownership interest and also served as director;
- approximately \$1 million in loans from in or about May 2004 through in or about March 2007 to MSP, a general partnership that Smith co-owned with McGinn. Over \$500,000 of this loan remains outstanding; and

- a total of approximately \$875,000 used to purchase preferred stock in the Firm from in or about December 2004 through in or about May 2006.
32. From in or about September 2006 through in or about March 2007, Smith also received personal loans of approximately \$590,000 from the Related Entities that were funded by investments made in the Income Note LLCs.
33. From in or about February 2007 through in or about March 2008, Smith also misused offering proceeds from the Income Note LLCs to make loans between the various LLCs totaling approximately \$1.38 million. For example, on or about February 5, 2007, TAIN lent FEIN approximately \$450,000 using funds received from the income note offerings. Approximately \$355,000 of this loan is still outstanding.
34. The PPMs for the Income Note LLCs failed to disclose that the LLCs would be lending to, or borrowing from, each other.
35. By misusing offering funds, the Firm and Smith violated NASD Conduct Rules 2330 and 2110.

SECOND CAUSE OF ACTION

OFFERING FRAUD: MISREPRESENTATIONS/OMISSIONS (WILLFUL VIOLATIONS OF SECTION 10(B) OF THE EXCHANGE ACT AND RULE 10B-5 THEREUNDER, NASD CONDUCT RULES 2120 AND 2110 AND IM-2310-2)

36. The Department realleges and incorporates by reference paragraphs 1-35 above.
37. The Firm and Smith failed to disclose the following material facts in connection with the four income note offerings:
- The Income Note LLCs would invest in Related Entities;
 - The Income Note LLCs would be making loans to Related Entities;

- The majority of offering funds would be used for transactions involving Related Entities;
- The potential conflicts of interest associated with the transactions involving the Related Entities;
- The Income Note LLCs would be making loans to each other;
- The Income Note LLCs would be engaged in long-term lending activity; and
- The majority of offering funds would be invested in illiquid, non-public companies.

38. Smith also misrepresented in the PPMs and in the Subscription Agreements that investments would only be accepted from accredited investors. As alleged in the Third Cause of Action below, however, there were numerous non-accredited investors in each offering.

39. Smith also misrepresented in the PPMs and in the Subscription Agreements that the Firm would only receive a 2% commission/fee from income note offerings. In fact, the Firm received annual commissions from the inception of the offerings totaling approximately \$7.5 million, approximately an 8.4% fee.

40. The Firm, acting through Smith, knew, or was reckless in not knowing, that the PPMs and Subscription Agreements contained these misrepresentations. Nevertheless, the Firm sold the income notes without corrective disclosure to potential investors.

41. As alleged above in paragraph 31, the Firm and Smith received a financial benefit from the transactions involving the Related Entities.

42. As part of the course of conduct described in paragraphs 36-41 above, the Firm and Smith, in connection with the purchase or sale of securities, directly or indirectly, by the use of the means or instrumentalities of interstate commerce, or of the mails, or of

any facility of any national securities exchange, knowingly or recklessly: employed devices, schemes or artifices defraud; made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; engaged in acts, practices, or courses of business which operated or would operate as a fraud or deceit upon any person; or effected transactions in, or induced the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.

43. By misrepresenting and omitting material facts, the Firm and Smith willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and violated NASD Conduct Rules 2110 and 2120 and IM-2310-2.

THIRD CAUSE OF ACTION

Sale of Unregistered Securities (NASD Conduct Rule 2110)

44. The Department realleges and incorporates by reference paragraphs 1-43 above.
45. During the Offering Period, the Firm, acting through Smith, sold securities in the form of income notes issued by FIIN, FEIN, TAIN and FAIN. Among other things, Smith directed the sales efforts relating to the notes.
46. At no time was there a registration statement in effect for the income notes.
- Furthermore, these notes were not eligible for exemption from registration. Each of these offerings claimed an exemption from Registration pursuant to Rule 506 of Regulation D.

47. There were more than 35 non-accredited investors in each of the offerings, making them ineligible for the claimed Rule 506 exemption.
48. Furthermore, the four note offerings were not separate and distinct, and were, therefore, subject to integration because, among other things: (1) each successive note offering was issued prior to the previous note offerings reaching its maximum offering amount; (2) the terms and structure of each of the four note offerings were virtually identical; and (3) for at least a portion of the Offering Period, investor funds were raised concurrently for all four offerings.
49. The four integrated offerings had a total of approximately 250 non-accredited investors, which also made them ineligible for the Rule 506 exemption.
50. By selling unregistered securities, the Firm and Smith contravened Section 5 of the Securities Act and thereby violated NASD Conduct Rule 2110.

FOURTH CAUSE OF ACTION

Misrepresentations/Omissions (NASD Conduct Rule 2110)

51. The Department realleges and incorporates by reference paragraphs 1-50 above.
52. On or around January 25, 2008, Smith sent to the Junior Note holders of all four Income Note LLCs a letter informing them that their annual interest rate would be reduced from 10.25% to 5% due to the effects that market conditions and the credit crisis were purportedly having on the LLCs.
53. In this letter, Smith misrepresented that the Firm and the McGinn Smith Affiliates, which had been receiving fees/commissions from the Income Note LLCs, would

“suspend” collection of further fees and commissions to assist the financial condition of the LLCs.

- 54. In fact, the Firm and the McGinn Smith Affiliates continued to take fees and commissions, collecting approximately \$6.7 million from 2008 to 2010.**
- 55. In 2008, the Firm stopped redemptions for all note holders of the Income Note LLCs. On October 22, 2008, Smith wrote a letter to all of the note holders advising them, among other things, that the Income Note LLCs would be unable to redeem notes on November 15, 2008, due to the illiquidity of the investments made by the LLCs. Smith again blamed this development on, among other things, the “current condition in financial credit markets” and the “liquidity crises.”**
- 56. In this letter, Smith represented that the financial condition of the Income Note LLCs, and their ability to repay investors would be re-evaluated the following year. The letter also announced a restructuring of the notes that substantially extended the maturity dates on all classes of the income notes. For example, the maturity dates for the Junior Subordinated Notes, typically five years from purchase, were extended until August 2023.**
- 57. This letter also outlined a restructuring plan for each of the income notes that substantially extended the maturity dates for several years for each of the classes of the notes and unilaterally lowered the interest payments for each.**
- 58. In the January 25, 2008 letter to Junior Note holders and the October 22, 2008 letter to all note holders, Smith failed to disclose that the basis for the Income Note LLCs’ poor financial condition was due, at least in part, to his decision to lend/invest the**

majority of investor funds in one of the illiquid Related Entities that had limited or no revenues or were in financial distress.

59. In his October 22, 2008 letter to note holders, Smith also misrepresented that the Firm and the McGinn Smith Affiliates would be making their own "sacrifices" and would "forfeit" all annual fees and commissions as part of the proposed note restructuring to "improve liquidity." As noted above, this was a false statement; the Firm received approximately \$6.7 million in fees and commission after this letter was sent to investors.

60. By making misrepresenting and omitting facts in communications with investors, Smith violated NASD Conduct Rule 2110.

FIFTH CAUSE OF ACTION
Supervisory Violations
(NASD Conduct Rules 3010 and 2110)

61. The Department realleges and incorporates by reference paragraphs 1-60 above.

62. From in or about 2003 through in or about 2008, the Firm's primary revenues were derived from private placements, including the four income note offerings.

63. During this period, the Firm, acting through Smith, failed to establish and maintain a supervisory system, and failed to establish, maintain and enforce written supervisory procedures, that were reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules applicable to private securities offerings and related suitability, disclosure, verification of investor accreditation status and other sales practice-related issues.

64. As the Firm's Chief Compliance Officer and a supervisory principal, Smith reviewed and accepted the individual investments for the income note offerings. In doing so, Smith relied almost exclusively on the information provided in the Subscription Agreements and Purchaser Questionnaires submitted by each investor. There was no information in those documents relating to the investor's liquid net worth or other investments; therefore, Smith had insufficient information to assess the suitability of the investment.
65. Many of the investor documents that Smith approved were deficient. They were incomplete or missing financial information necessary to ascertain whether the investor was "accredited" under Regulation D or whether the investment was suitable. After the investor submitted the questionnaires to the Firm, many of them were altered to increase the person's reported net worth and/or income to qualify them as accredited.
66. Smith knew, or should have known, that the documents had been altered. At the very least, the obvious alterations should have caused Smith to question the accuracy of the documentation and whether the investor was accredited.
67. Smith failed to ensure that the forms were complete and accurate and to otherwise respond reasonably under the circumstances. Instead, Smith continued to approve the income note investments notwithstanding these deficiencies.
68. As alleged above, the PPMs and Subscription Agreements for the income notes represented that investments would only be accepted from accredited investors. Nevertheless, Smith approved and accepted approximately 250 investments by non-accredited investors.

69. By failing to establish, maintain and/or enforce a supervisory system and written supervisory procedures that were reasonably designed to achieve compliance with all applicable regulatory requirements with respect to the note offerings, the Firm and Smith violated NASD Conduct Rules 3010 and 2110.

SIXTH CAUSE OF ACTION

Providing False Documents to FINRA (FINRA Rules 8210 and 2010)

70. The Department realleges and incorporates by reference paragraphs 1-69 above.
71. On or about September 30, 2009, the staff sent a letter to the Firm requesting, pursuant to FINRA Rule 8210, all documentation concerning loans received by Smith, McGinn and other Firm employees from certain Related Entities, including TDMCF, and CCV, two LLCs controlled by McGinn and Smith.
72. On or about November 16, 2009, the Firm, acting through Smith and McGinn, submitted to FINRA staff copies of 23 promissory notes relating to loans that Smith and McGinn received from TDMCF and CCV.
73. Six of the notes were signed by Smith as the borrower and related to loans that he had received from TDMCF and CCV.
74. Fourteen of the notes were signed by McGinn and related to loans that he had received from TDMCF and CCV. The remaining notes were signed by MR, a Firm registered representative.
75. Each of the promissory notes signed by the Firm, Smith and MR included a signature date that was during the time period from in or about October 2006 through in or about October 2009.

76. Each note contained information regarding the specifics of the notes, such as the amount of the loan, interest rate, maturity date (in all cases the maturity date is six years from the date of the original loan). The final page on each promissory note stated "IN WITNESS WHEREOF, this Note has been executed and delivered on the date specified above by the duly authorized representative of the Maker."
77. This certification was false. In fact, the subject promissory notes that the Firm provided were actually prepared, dated and signed by McGinn, Smith and MR from in or about November 2, 2009 through in or about November 15, 2009.
78. The Firm, Smith and McGinn provided the subject promissory notes to FINRA staff knowing that the dates reflected thereon were false. Nevertheless, the Firm, Smith and McGinn did not advise the FINRA staff that the copies of the promissory notes they produced to FINRA staff had been backdated.
79. By providing false documents to FINRA staff, the Firm, Smith, and McGinn violated FINRA Rules 8210 and 2010.

RELIEF REQUESTED

WHEREFORE, the Department respectfully requests that the Panel:

- A. order that one or more of the sanctions provided under FINRA Rule 8310(a) be imposed, including that Respondents McGinn, Smith & Co., Inc. and David L. Smith be required to disgorge fully any and all ill-gotten gains and/or make full and complete restitution, together with interest;
- B. order that the Respondents bear such costs of proceeding as are deemed fair and appropriate under the circumstances in accordance with FINRA Rule 8330; and

- C. make specific findings that Respondents McGinn, Smith & Co., Inc. and David L. Smith willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

FINRA DEPARTMENT OF ENFORCEMENT

Dated: April 5, 2010



Michael J. Newman, Senior Regional Counsel
John M. D'Amico, Regional Chief Counsel
FINRA Department of Enforcement
581 Main Street, Suite 710
Woodbridge, NJ 07095
(732) 596-2030; Fax: (202) 721-6557
michael.newman@finra.org
john.d'amico@finra.org